

Understanding exchange-traded index funds

Exchange-traded index funds (ETFs) combine features of traditional index mutual funds with the trading efficiencies associated with stocks. Intraday market pricing, cost and tax efficiencies, leverage, and short selling opportunities are some of the benefits of ETFs versus traditional index funds.

Exchange traded index funds (ETFs) are investment vehicles with unique features and benefits that may enhance overall portfolio performance. While closely related to index mutual funds, index ETFs differentiate themselves by trading on an exchange like a stock. First created in 1993, net assets in these funds have surged, a sign of their growing popularity.

Essentially hybrid investment vehicles combining features of stocks and mutual funds, ETFs have several advantages for investors:

Intraday liquidity and continuous pricing

Since ETFs are traded on an exchange, they trade daily between investors at market prices. A traditional mutual fund is purchased or redeemed between an investor and the fund, at net asset value (NAV), which is determined only once a day at market close.

Cost and tax advantages

ETFs tend to be more tax efficient than traditional mutual funds; investors control the timing of a taxable event, and ETFs do not realize appreciable capital gains within the fund because of the passive nature of index investing. Index rebalancing, which can necessitate rotations in ETF holdings, can result in distributable capital gains. Expenses and fees for index ETFs tend to be low because of fewer marketing and distribution costs; increasing competition is also helping to lower fees. However, investors do pay commissions on ETF trades just as they do on stocks, so an investor who trades frequently may find ETFs more expensive than other funds. In addition, tax rates on ETF gains may be contingent on the legal structure or underlying assets held by an individual fund; tax advice is recommended when considering these investments.

Sector, style, and global diversification

Like mutual funds, ETFs can be a good way to increase portfolio diversification but with the added benefit of trading efficiency. Existing ETF products range from total market funds to sector funds, style-based funds such as value or growth, fixed income index funds, regional funds, and country-specific funds.

Margin trading, short selling, and options

A key difference between ETFs and mutual funds is the availability of margin trading, short selling (even on a downtick), and options on many of these funds. Because ETFs are based on indices, certain instruments that cannot be shorted when directly owned, like bonds, can be shorted when held as a constituent of an ETF. Entire sectors, or a style variation, can be shorted on an aggregate, rather than a stock-by-stock, basis. Other stock-like features include the use of market orders, limit orders, or stop orders in the purchase or sale of an ETF. The universe of ETFs includes more than just the index funds we have discussed.

Consult Emil to see if ETFs may be an appropriate addition to your portfolio.

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